

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]:TL-N-7614-98

date:

to: Chief, Examination Division, [REDACTED] District
Attn: Branch 1 Case Manager [REDACTED]

from: District Counsel, [REDACTED] District, [REDACTED]

subject: [REDACTED] - Rate
support Payments.

This memorandum is in response to your request for advice regarding the treatment of rate support payments received by [REDACTED] from [REDACTED]. These issue are being coordinated with Robert Casey and Willie Armstrong in our National Office. The advice in this memorandum is subject to post-review in the National Office, which we will expedite. If you have any questions, please call the undersigned at [REDACTED], voice mail box # [REDACTED].

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ISSUES

1. Whether [REDACTED] should be required to include retail, [REDACTED], and [REDACTED] support payments from [REDACTED] in income in the year in which they are received.

2. If [REDACTED] is permitted to treat the [REDACTED] support payments as an adjustment to basis rather than current taxable income, should the basis adjustment be made to the [REDACTED] asset or the [REDACTED]?

3. If [REDACTED] is permitted to treat the [REDACTED] support payments as an adjustment to the basis of the [REDACTED] rather than an adjustment to the underlying [REDACTED] or as taxable income, would that constitute an unauthorized change in the method of accounting?

PROPOSED CONCLUSIONS

1. [REDACTED] is not required to include retail, [REDACTED] or [REDACTED] support payments from [REDACTED] in income in the year in which they are received.

2. The [REDACTED] support payments should be applied as an adjustment to the basis of the [REDACTED] to which it relates.

3. Requiring [REDACTED] to treat the [REDACTED] support payments as an adjustment to the basis of the underlying [REDACTED] does not constitute an unauthorized change in the method of accounting.

FACTS

The relevant facts are more fully set forth in the Technical Advice Memorandum ("TAM") issued to [REDACTED] on this issue [REDACTED], on [REDACTED], and in the briefs filed by the government and [REDACTED] in the case before the United States Tax Court concerning the [REDACTED] tax year, Docket No. [REDACTED]. They are briefly summarized below.

The treatment to be afforded rate support payments (defined below) by both [REDACTED] and its wholly owned subsidiary, [REDACTED], has been an issue in the three prior audit cycles, [REDACTED], [REDACTED], and [REDACTED]. For the [REDACTED] and [REDACTED] cycles, only retail rate support and [REDACTED] support were at issue. In the [REDACTED] cycle, [REDACTED] support became an additional issue and all three rate support programs are at issue in the current [REDACTED] cycle. The [REDACTED] tax year was tried at Tax Court in [REDACTED].

The issue raised during the examination of the rate support issue included the impact of rate support payments on both [REDACTED] and [REDACTED]. The initial proposed impact on [REDACTED] was to treat the rate support payments it received from [REDACTED] as currently taxable income instead of the deferred treatment reported. During the Tax Court litigation the IRS took the position that both the retail and [REDACTED] rate support payments should be treated as basis reductions to the underlying retail and [REDACTED] loans. See, Brief for Respondent, Docket No. [REDACTED], page 40. Thus, [REDACTED]'s deferred income treatment for retail and [REDACTED] rate support payments was permitted.

The proposed impact on [REDACTED] was to require [REDACTED] to defer its deduction for rate support payments made to [REDACTED] until such time as [REDACTED] recognized the rate support payments into its taxable income. However, the Tax Court held that [REDACTED] is not required to defer the deduction for the rate support payments to match the deferred recognition of the payments by [REDACTED]. See [REDACTED].

[REDACTED] provides financing to eligible buyers and lessees of [REDACTED] products. During the period [REDACTED] through [REDACTED], [REDACTED] offered three types of incentive financing programs through [REDACTED] dealers and [REDACTED]. They are described below:

Low Interest Rate Financing to Non-Fleet Buyers

Beginning in [REDACTED], [REDACTED] offered consumer incentives in the form of below-market interest rate loans to retail customers ([REDACTED] customers) to encourage sales at a time when interest rates were high. This incentive financing was offered by [REDACTED] through [REDACTED] dealers and [REDACTED]. The program was structured so that [REDACTED] rather than [REDACTED] dealers or [REDACTED] would bear the cost of the program. [REDACTED] agreed to pay [REDACTED] the discounted present value of the difference between the interest that would have been earned on the note had it borne a market rate of interest, and the interest that would be earned at the below-market rate. This payment is referred to as the "Retail Rate Support Payment" (RRSP). [REDACTED] recognizes the RRSP income as a reduction in the basis of the underlying loan and includes as income, the customer payments over the life of the loan.

Low Interest Rate Financing to [REDACTED] Buyers

For many years in order to meet the competition of other manufacturers for sales with [REDACTED] buyers (e.g. rental agencies), [REDACTED] agreed to offer these [REDACTED] buyers low interest rate financing. The financing negotiated with the [REDACTED] customer is provided, with the support of [REDACTED] by [REDACTED] or in some cases another unrelated financial institution preferred by the [REDACTED] customer.

Under the subject financing arrangement [REDACTED] agrees to finance eligible fleet buyers' loans at below-market interest rates. [REDACTED] in turn has agreed to pay [REDACTED] or some other unrelated financial institution, the present value of the difference between the interest that would have been earned on the loan had it borne a market interest rate and the interest that would be earned at the below-market rate. This payment is referred to as the "Fleet Financing Payment" (FFP). [REDACTED] recognizes the FFP income on a deferred basis over the life of the loan.

Low Interest Rate Financing Relative to the [REDACTED] and [REDACTED] Leasing Programs

The [REDACTED] began in the fall of [REDACTED]. Under this plan, [REDACTED] dealers acted as agent for [REDACTED] in executing vehicle leases with lessees for either [REDACTED] or non-[REDACTED] vehicles. On [REDACTED], [REDACTED] introduced its [REDACTED] Plan ([REDACTED]). [REDACTED] dealt with the leasing of [REDACTED] vehicles, and [REDACTED] became limited to the leasing of non-[REDACTED] vehicles ([REDACTED]).

One of the major changes to [REDACTED]'s leasing activity was a change in the legal relationships/responsibilities of the parties to the lease arrangement. [REDACTED] maintains that the change was made in order to create increased responsibility and liability on the dealer in connection with the leasing of [REDACTED] vehicles.

Under both [REDACTED] and [REDACTED], the dealer no longer acts as [REDACTED]'s agent in executing the lease agreement, but rather acts as lessor when entering into a lease agreement directly with a retail customer. If acceptable to [REDACTED], the dealer-lessor subsequently assigns the lease and the vehicle to [REDACTED].

In [REDACTED], [REDACTED] introduced its [REDACTED] program. Under this program the customer makes a single up-front payment on the lease reflecting a lower total payment as compared to a standard [REDACTED]. Effective in [REDACTED], [REDACTED] was expanded to include non-[REDACTED] vehicles.

During [REDACTED] through [REDACTED], incentive leases were entered into with retail customers that contained below-market (implicit interest) lease rates offered by the dealers through [REDACTED]. The incentive lease programs were offered under [REDACTED] and [REDACTED]. Incentive financing programs were not offered under [REDACTED] (non-[REDACTED] vehicles) or under [REDACTED] for non-[REDACTED] affiliated vehicles during the period [REDACTED] through [REDACTED].

During periods when incentive lease programs are offered, [REDACTED] will earn less lease income on those leases carrying below-market lease rates. [REDACTED] has agreed to make [REDACTED] whole by paying [REDACTED] the lease rate support payment which is the difference between the present value of the total lease payments without a reduced lease rate and the present value of the total lease payments with a reduced lease rate.

Lease Rate Support is calculated as follows:

Monthly rental payment at the non-incentivized rate	\$ [REDACTED]
Monthly rental payment at the incentivized rate	[REDACTED]
Monthly rent difference	\$ [REDACTED]
less: Early Termination Factor	[REDACTED]
Net Difference	\$ [REDACTED]
X Term of 36 months	\$ [REDACTED]
Present Value	\$ [REDACTED]
plus: 1-month delay	[REDACTED]
Total Lease Support Payment	\$ [REDACTED]

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In response to an inquiry from the audit team regarding the treatment by [REDACTED] of the [REDACTED] payments, [REDACTED] responded that they do not recognize income from the payment of [REDACTED] rate support payment made by [REDACTED] under the rate-support programs. Rather, such payments reduce the basis of the applicable vehicle purchased by [REDACTED] from the dealer.

It should be noted that this treatment of the rate support payment by [REDACTED] (i.e., a basis reduction of the leased vehicle) was not mentioned in the prior cycle by [REDACTED].

The above response from [REDACTED] regarding the treatment of the lease rate support payments was later contradicted by its response to IDR [REDACTED]. In said response they state that:

[REDACTED]

[REDACTED]

[REDACTED] " (emphasis added)

Included with this response, [REDACTED] filed an affirmative issue (which, as discussed below, has now been conceded by [REDACTED] for [REDACTED] seeking to reduce taxable income in each year [REDACTED] through [REDACTED] caused by reversing [REDACTED]'s reported income amortization and making a downward basis adjustment to the leased vehicles for the lease rate support payments.

The affirmative issue sought to reduce taxable income by \$[REDACTED], \$[REDACTED], \$[REDACTED] and \$[REDACTED] for tax years [REDACTED], [REDACTED], [REDACTED] and [REDACTED], respectively. The reduction to taxable income was based on [REDACTED]'s position that the lease rate support payments received by [REDACTED] from [REDACTED] reduce the cost of the leased vehicle, thereby reducing [REDACTED]'s tax basis in the vehicle.

The net effect of the change resulted in a reduction to taxable income in each year as follows:

[REDACTED]	\$ [REDACTED]
	\$ [REDACTED]
	\$ [REDACTED]
	\$ [REDACTED]
	\$ [REDACTED]
Total	\$ [REDACTED]
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[REDACTED] provided an amortization schedule which reflects the amount of lease rate support billings recognized into income by [REDACTED] over the period [REDACTED] through [REDACTED], which include both [REDACTED] rate support and [REDACTED] rate support. [REDACTED] stated that the economic accrual method was used for the [REDACTED] contracts through [REDACTED] and the straight-line method was used for [REDACTED] contracts acquired thereafter. Amortization was over the average contract term. [REDACTED] also stated that it is unable to separately identify the [REDACTED] and [REDACTED] billings, thus, it is assumed that

the economic accrual method of reporting the lease rate support income and the switch to the straight line method in [REDACTED] applies equally to [REDACTED] rate support.

[REDACTED], however, now agrees with the audit team's position that the lease rate support payments should be applied as an adjustment to the basis of the lease.

Discussion and Analysis

Retail, Fleet, and Lease Rate Support Payments

Based upon both oral and written advice received in connection with the trial of the [REDACTED] year, Chief Counsel's Office has concluded that [REDACTED] properly did not include the amounts received from [REDACTED] as taxable income and that [REDACTED] properly reduced its basis in the assets by the support amounts it received. For the retail program, the payments at issue are viewed as payments by [REDACTED] to [REDACTED] to induce [REDACTED] to purchase notes from [REDACTED] dealers for an amount greater than the notes' fair market value. In the fleet program, the payments are to induce [REDACTED] to lend at below-market rates. Although not specifically considered for the trial, lease rate support is closely related to the retail rate support scenario. The lease merely represents the purchase of a portion of the vehicle in terms of its use for a specified period of time (e.g. 24, 36 months lease). For the lease rate support program, the payments are to induce the purchase of the lease contract with the below-market rate of interest.

In Brown v. Commissioner, 10 B.T.A. 1036, 1054-1055 (1928), acq., VII-2 C.B. 5, the Board of Tax Appeals held that an amount received by a buyer from a third party to induce him to purchase property is a reduction of the buyer's cost of the property, rather than income to the buyer. In Freedom Newspapers, Inc. v. Commissioner, T.C. Memo. 1977-429, the Tax Court held that the buyers basis in the property must be decreased by amounts paid by a third party to induce the purchase. See also Rev. Rul. 76-96, 1976-1 C.B. 23 (new car purchaser must reduce basis in automobile by amount of manufacturer rebate); Rev. Rul. 73-559, 1973-2 C.B. 299 (basis in acquired mortgage is reduced by amount of inducement payment).

Under Brown and Freedom Newspapers, the retail, fleet and lease rate support payments from [REDACTED] to [REDACTED] are not includible in as income to [REDACTED]. For retail and lease rate support the payments are made to induce the purchase of the note and lease, respectively, both of which contain below-market rates of interest. Consequently, [REDACTED] must reduce its basis in each note or lease by the amount of the related rate support payment. This

theory focuses on the nature of the transaction as a property purchase by [REDACTED]

For Fleet rate support, the payments are made to induce [REDACTED] to lend at a below-market rate interest. In Rev. Rul. 73-559, 1973-2 C.B. 299, the service examined special assistance programs between GinnieMae and FannieMae to support the market for certain mortgages. Pursuant to the program FannieMae was committed to purchase mortgages at a price that was higher than the market price for such mortgages. Upon making such a purchase, FannieMae was entitled to receive from GinnieMae an amount equal to the difference between the purchase price and the market price. Thus, GinnieMae bore the financial burden of the payments, and the mortgagor receives the higher than fair market value payment for the mortgage. The Service held that the basis of mortgages acquired by FannieMae is the amount paid less any payment received from GinnieMae to induce FannieMae to acquire the mortgage from the originator. In the instant case [REDACTED] like FannieMae, pays higher than market value for the fleet note receivable, with the assurance that it will receive the differential payment form [REDACTED]

Since the [REDACTED] rate support transactions are substantially similar to the GinnieMae/FannieMae transaction in Rev. Rul. 73-559, we believe that [REDACTED] may treat the rate support payments (retail, fleet and lease) in the same manner as that determined in Rev. Rul. 73-559, i.e. as not includible in income but as a reduction in basis of the acquired asset.

We would note here that for the fleet finance transactions, the [REDACTED] payment to [REDACTED] is not to induce [REDACTED] to purchase installment notes between the vehicle customer and the selling car dealer. Rather, the payments are to induce [REDACTED] to directly make below-market rate financing available to the purchasing fleet customer. In contrast to the lease and retail rate support payments, which require a reduction in the purchased lease or note, the fleet rate support payment is a reimbursement to [REDACTED] which effectively reduces the net amount that [REDACTED] pays out in the lending transaction to the fleet buyer. Because the note from the fleet buyer reflects the face amount (vs. market value) of the loan, [REDACTED]'s fleet rate support payments serve to reduce the amount advanced in the lending transactions. Through the reduction of the basis in the fleet financing note to the fleet purchaser, [REDACTED] realizes discount income over the term of the note. As set forth above, the inducements are more properly taken into account as basis reductions and not as income when received.

Lease Rate Support Basis Adjustment

The resolution of the issue above with respect to treating lease rate support payments as a basis adjustment begs the follow-up question: Which asset's basis should be adjusted? In the lease transaction, [REDACTED] purchases both the lease and the underlying vehicle from the dealer.

If the adjustment is to the leased vehicle, then the effect on taxable income is through the cost recovery of the leased vehicle. That is, because the basis of the leased vehicle is reduced by the lease rate support payment, less total cost recovery would occur. Since cost recovery is under the Modified Accelerated Cost Recovery System (MACRS), the lease rate support is in effect reported into taxable income at the MACRS rate for five year property. Under MACRS, the percentage rate over years one through six would be 20%, 32%, 19.2%, 11.52%, 11.52% and 5.76%, respectively. In [REDACTED], [REDACTED] elected the alternative depreciation system, therefore, the [REDACTED] lease rate support is in effect reported into taxable income at the straight line rate over 5 years.

If the adjustment is to the lease receivable, then the effect on taxable income is to report the lease rate support payment as income on a straight line basis over the average life of the lease, typically two to three years.

After the lease is executed between the [REDACTED] dealer and the lessee, both the lease and vehicle are transferred to [REDACTED] whereby [REDACTED] steps in as lessor. When the lease contains a below-market lease rate, [REDACTED] will receive a lease rate support payment from [REDACTED]. The lease rate support payment received by [REDACTED] from [REDACTED] can be applied as a basis adjustment to the asset to which it relates. See Freedom Newspapers, Inc., 36 T.C.M. 1755 (1977); Brown v. Commissioner, 10 B.T.A., 1036 (1928), acq., VII-2 C.B. 5.

Resolution of this issue turns on an analysis of the underlying transaction for which the rate support payments were received. In the present case, the genesis of the rate support payment is the lease agreement. It is the lease agreement that contains the below-market lease rate which in turn results in [REDACTED] being obligated to make [REDACTED] whole on those leases. Therefore, the lease rate support payment is intrinsically tied to the lease receivable and that is the asset for which a basis adjustment should be made.

As discussed above, [REDACTED] reported lease rate support payments received from its parent company, [REDACTED] as deferred income. Through [REDACTED], the income recognition was under the economic accrual method over the average life of the related contract. Beginning in [REDACTED], [REDACTED] recognized such income under the straight line method over the average life of the related contract. On [REDACTED], [REDACTED] filed an affirmative issue (claim) seeking reduce taxable income for the years [REDACTED] through [REDACTED] on the basis that the rate support payments should be treated as an adjustment to the basis of the vehicle. The taxpayer now agrees that the lease rate support payment received by [REDACTED] from [REDACTED] should be applied as a basis adjustment to the lease rather than to the vehicle. As discussed below, [REDACTED] will be permitted to change the reporting of the lease rate support payments from its present method to treating the payments as an adjustment to the lease receivable.

Accounting Method Change

Ordinarily, [REDACTED]'s change in [REDACTED] and the change proposed by the affirmative issue raised in [REDACTED], would be denied on the basis that it constitutes a change in the method of accounting for which [REDACTED] would be required to seek permission for the change by filing a Form 3115, Application for Change in Accounting Method. However, since the Service has already permitted [REDACTED] to make a basis adjustment to its notes receivables for retail and fleet rate support payments, [REDACTED] will be permitted to make a basis adjustment for the lease rate support payments consistent with the advice of this memorandum.

Should you have any questions regarding this matter, please contact, the undersigned attorney at [REDACTED].

[REDACTED]
District Counsel

By: _____

[REDACTED]
Attorney